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129

RESEARCH STUDY

BUREAU OF INTELLIGENCE AND RESEARCH

EXCISE

April 28, 1971

OIL: CONFRONTATION AFTERMATH AND OUTLOOK

The Libyan oil agreement of April 2 climaxed a successful year-long campaign by members of the Organization of Petroleum Exporting Countries (OPEC) to force higher taxes on international oil companies. This paper is a preliminary effort to summarize the course of the confrontation and to discuss its major effects and the outlook. The paper was drafted while oil negotiations continued in Algeria, Nigeria and the Eastern Mediterranean. Most figures given are approximations subject to revision when fuller data become available.

ABSTRACT

The five-year oil agreement with Libya culminated a series of new oil tax arrangements negotiated with or imposed on international oil companies for up to five years, raising annual OPEC oil revenues by at least 40 per cent since last summer. The companies are now attempting to shift the cost of the tax increases to oil consumers in the major international markets of Western Europe and Japan, where the initial impact is much greater than that on the protected United States market.

If shifted in full the first-year gross cost to consumers will be at least $3 billion. On the average, this will raise West European and Japanese industrial prices and import costs by about two per cent, not enough to affect most trade relationships significantly. The net

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impact on industrial countries will be less, since much of their increased import costs will return in the form of increased export earnings and investment inflows from the oil-exporting countries. Less developed oil importers, however, have less prospect of offsetting increases in their earnings.

Interest will be greatly increased in reopening the Suez Canal as a short term effort to reduce oil costs and reduce OPEC's strength. The consensus is that the Canal would end the tanker shortage, decrease oil transportation costs and restore supply flexibility. This is expected to reduce consumer oil prices.

In the longer term, consumer governments may assume greater control of the energy industry to ensure competition among fuels and their sources and to provide greater security of energy supplies. They are likely to seek greater direct access to OPEC and non-OPEC sources of supply, reducing the role of the international oil companies in the next several years.

Another important effect of the confrontation, in the opinion of many observers, is a permanent alteration in the relationship between the companies and governments of oil-producing states. Having once wielded control over their oil resources, the governments are more likely to exercise their authority when conditions are appropriate, as they were in recent months due to a combination of circumstances which put oil in tighter supply than it had been for many years.

Because of this factor, there is little confidence that the five-year agreements will survive unaltered until 1975. One oil economist

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feels that OPEC can raise oil taxes several times without reducing sales because of the length of time required to reduce reliance on OPEC oil. This is the most pessimistic assessment heard and may overestimate OPEC's capabilities although it is difficult to assess the situation at this point.

In Libya the most important factor, the amount of oil exported, apparently is not covered by the agreement. Libya's financial position permits it to reduce oil output further if it should so desire. Because of Libya's location a substantial restriction in its production would adversely affect the tanker situation and therefore prices as long as the Suez Canal remains closed. There is no evidence, however, that Libya intends to restrict production from existing fields any further.

The expensive Libyan settlement may also cause some adjustments in the earlier Persian Gulf oil agreement but hopefully will not undermine the agreement entirely.

It is too early to draw firm conclusions regarding the future conduct of OPEC or its members. It is not even clear whether the confrontation is over or will resume, but a breathing spell of at least a few months is a good possibility. As things now stand, Western Europe can withstand all but an extended oil supply interruption and few OPEC members seem prepared to pose such a challenge. OPEC's next move may be revealed after its next conference, scheduled for July 12 in Vienna.

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Where we stand. The year-long threat of a world oil crisis ebbed -- at least temporarily -- April 2 when Libya signed a five-year oil tax agreement to climax what one oil economist called "a transfer of wealth to oil exporting centers unprecedented in the history of the commodity trade".1/

The Tripoli agreement was the key in a series of often tumultuous negotiations or unilateral actions in which, since last summer, members and allies of the Organization of Petroleum Exporting Countries (OPEC)2/ won oil tax increases totalling more than $3 billion on top of the more than $7 billion annual revenues their oil exports now earn. The Libyan pact set definite economic limits for unfinished negotiations in Algeria, Nigeria and the Eastern Mediterranean. The agreement reduces the likelihood of a coordinated interruption of oil supplies to the industrial world, particularly from short-haul Mediterranean sources, which exercise so much leverage on transportation costs. OPEC countries effectively employed partial short-haul supply interruptions and the embargo threat in the past year to win the first general oil price increase in more than 10 years.

In the view of many Western observers the new tax arrangements do not guarantee stability. Petroleum now has 55 per cent of the world energy market and is in heavy demand, displacing other fuels. Oil provides 60 per cent of Western Europe's energy and 68 per cent of Japan's energy. OPEC members and allies have sovereignty over close to 80 per cent of current Free World oil production outside the United States. Since alternative energy sources are not readily available, OPEC, in the reported opinion of Dr. M. A. Adelman, Massachusetts Institute of Technology,3/ can raise taxes and thus prices "several times" without reducing sales if it can effectively exercise its monopoly power and unless consuming nations unite. This is the most pessimistic assessment heard. He suggested, however, that OPEC members more likely will fail to cooperate effectively and this eventually will result in a new oil surplus and a return to the buyer's market of the 1950s and 1960s.

1/ Paul H. Frankel, Petroleum Economics Ltd. (London), quoted in Petroleum Intelligence Weekly (PIW), April 5, 1971, p. 5.

2/ OPEC members are Abu Dhabi, Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia and Venezuela. Nigeria reportedly may join.

3/ PIW, op. cit.

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Assuming the new tax arrangements endure for the near term, Western attention now shifts from the adequacy of oil supplies to their cost (who will bear it, how to reduce it) and to the prospects of stability of energy supplies.

The full ramifications of the oil confrontation will not become evident for some time. Some preliminary short-run statistics based on initial and incomplete reports of the recent agreements are set forth in the attached tables.

Some of the Major Effects. Major oil exporters have obtained per unit crude oil revenue increases ranging from 30 per cent for Indonesia to about 90 per cent for Libya since last summer (Libya's increase is to drop to the equivalent of about 80 per cent when the Suez Canal re-opens and tanker rates decrease). If the oil market sustains these increases, non-OPEC exporters, such as the Soviet Union, should also eventually obtain increased unit returns on oil exports.

In gross terms the first-year revenue increase for OPEC oil exporters will be at least $3 billion, which will have to come out of company profits or consumer pockets or both. In the Middle East and North Africa, where five-year agreements were signed, the cumulative extra oil income through 1975 is put at $15 billion or more, assuming normal oil production levels in these areas.

If these costs are shifted fully to consumers, Western Europe and Japan, which import nearly all their petroleum needs, would pay 22-26 per cent more for oil initially, but this would raise their total import costs by only about two per cent on the average. This price increase would return prices to the levels of the late 1950s and early 1960s, although relative to prices of other commodities, prices of oil are still cheaper now than at that time.

The United States should be relatively unaffected. Imports amount to only 22 per cent of US oil consumption. One-fifth of imports come from Canada, whose oil export prices are not affected by the OPEC agreements. US import costs would rise by less than one per cent but US oil prices will remain substantially higher than those in Europe and Japan.

The net balance-of-payments impact on the industrial Free World will be much less than the gross impact. The developed countries will retrieve much of their increased import costs through increased exports to, and investments from, the largely less-developed oil exporting countries. Competition among exporters for that estimated cumulative $15 billion increase in income by the OPEC countries may be keen.

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The net impact on less-developed oil importing countries, however, will be closer to the gross cost, since such countries have little prospect of commensurate increases in exports or investment inflows unless they establish special arrangements with oil exporters. India, for example, faces higher oil import costs of about $30 million in the first year in addition to its normal trade deficit.

The impact of the oil price increases on total industrial costs in Western Europe and Japan would be less than two per cent on the average, although this varies greatly among industries, hitting the petrochemical sector hardest. These magnitudes are unlikely to affect relative trade positions significantly.

Reopening the Suez Canal will take on a high priority in efforts to reduce oil import costs. The Canal should lower transportation costs by ending the tanker shortage. It also would reduce the leverage of oil-producing countries, particularly that of short-haul producers such as Libya, on oil prices.

Europe and Japan are reviewing energy policies and the role of the international oil companies with the goal of gaining greater control over their oil supplies, perhaps through direct deals with producing countries. As the French experience in Algeria demonstrates, this course has its pitfalls.

The day when integrated international oil companies are reduced from owners of the oil they produce to contractors for OPEC governments seems closer. Companies may become more receptive to joint ventures with governments.

Having cooperated this time, oil-producing countries may form consortia to restrict production, maintain prices and avoid competition among themselves. They may also penetrate markets directly, be emboldened to legislate new terms for the oil trade, or to take over oil companies and their concessions.

Libya seems to have some grounds which from its point of view would justify further restriction of its oil production; any such substantial restriction would increase shipping costs and thus prices in the short run. Libya's oil reserves are low in relation to current production levels while oil revenues are high in relation to domestic needs.

The Persian Gulf may, during the next year or two at least, increase its share of the Western European oil market. The Gulf's gain would come at the expense of North Africa and Venezuela.

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The causes of the oil confrontation are as numerous as the effects. In the late 1950s and 1960s international oil prices dropped in response to an oil surplus which at times became an oil glut. Increased competition among producers was among the causes of the surplus. OPEC was formed in 1960 to maintain per-unit oil tax revenues, regardless of oil market prices. It succeeded and even increased average per unit returns slightly but, in OPEC's view, oil earnings, virtually the only source of foreign exchange for some members, did not keep pace with import costs. The oil industry disputes OPEC's terms of trade argument, claiming that profits suffered the most from falling prices. OPEC members gained experience in the oil trade over the years. Recently demand for oil surged in response to increased economic activity, the decline of the coal industry and the failure of nuclear power to expand as expected. Oil was relatively undervalued and seemed ripe for price correction.

The confrontation started when, with tankers in short supply due to high demand and the Suez Canal and Tapline closed, Libya capitalized on its proximity to the major international oil market, Western Europe, to force a tax increase effective September 1, 1970. The companies gave smaller tax increases to Persian Gulf oil at Gulf ports and Eastern Mediterranean pipeline terminals, and to Nigeria, whose oil contracts call for terms equivalent to the best in any part of Africa. Industry hopes that these increases would suffice were short-lived.

Sensing from Libya's success a rare opportunity to dictate new prices and "right old wrongs", OPEC's members opened a coordinated and aggressive campaign for further tax increases at the turn of the year. The oil companies united and demanded a five-year OPEC-wide agreement. They settled for a five-year Persian Gulf agreement effective February 15 (which excluded Iraqi and Saudi Arabian pipeline oil), and the second Libyan agreement of April 2, effective March 20, also for five years. Perhaps believing that their bargaining strength might be short-lived, these OPEC countries traded off their rights to change taxes for guaranteed unit revenues over five years.

Venezuela and Indonesia, who export primarily to the United States and Japan, respectively, did not negotiate but imposed new taxes effective March 18 and April 1. Venezuela, which said it will revise its new terms January 1, 1972, came out with a complex set of new categories and taxes whose full extent and implications are not yet clear even to the Venezuelans. Venezuelan crude and refined oils in heaviest demand bear the largest tax increases, with the new prices set at levels designed to keep Venezuelan oil competitive with Persian Gulf oil. The latter may now have a slight edge at European

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ports but a discretionary Venezuelan "freignt factor" of 7¢ may provide a hedge which the government can modify or eliminate according to market conditions. Indonesian increases are based on actual realized market prices and hence are tied closely to the Persian Gulf settlement.

The Libyan and Persian Gulf agreements provided bench marks for the remaining negotiations in Algeria and Nigeria and for Iraqi and Saudi Arabian oil piped to the Eastern Mediterranean. Taxes there must not be significantly higher than Libyan or Gulf taxes, with allowances for oil quality and transportation cost to market, if this oil is to remain competitive.

The new tax burden is the subject of current world-wide skirmishing between oil companies, consumers and their governments. The companies take the initial impact but say they cannot absorb the new costs and remain in business. Shell Oil, for example, says its average profit per barrel is 36¢, lower than the lowest tax increase of 38¢ in the Persian Gulf. The industry claims that profits margins must be maintained or expanded to finance 1970-1980 world oil needs which will equal total oil consumption from 1860 through 1969, or about 220 billion barrels in each period. Oil industry financial requirements in the 1970s conceivably could exceed $500 billion, the Chase Manhattan Bank warns.

Much of the tax increase already has been shifted to consumers. This has caused varying degrees of official displeasure in West Germany, Italy, Spain, India and Japan. Reaction has been particularly sharp when it appears that price increases exceed the OPEC tax increases, as has been reported in both Europe and Japan. In India, where the government initially refused to authorize both the price increase and commensurate foreign exchange allocations for crude oil imports, private refineries reduced import volume to the foreign exchange level appropriate to the new prices. Japan reportedly accepted Indonesia's 51¢ per barrel increase but has not yet accepted the full 38¢ Persian Gulf increase except in spot purchases. The world's largest oil importer, Japan obtains 90 per cent of its oil from the Persian Gulf, nearly all the remainder from Indonesia. The full test in Japan will come at mid-year, when many long-term contracts are to be renewed.

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In Western Europe much of the increase anticipated in the Libyan settlement was contained in price increases attributed to the earlier Persian Gulf agreement. Adverse official comment on the increases, in some cases obviously pro forma, comes mainly from consuming countries without major international oil companies of their own, Italy, Spain and West Germany.

Local conditions will determine eventual price levels. It is likely that dickering will continue for several months.

The scope for cost-cutting measures, in the short run, is rather limited. There is also little scope for immediate and large-scale substitution of other fuels for oil. West Germany has abolished regulatory restraints on oil supply and reduced heavy fuel oil taxes, as other countries are considering doing. The oil industry prefers the tax-cutting approach, since in Europe taxes constitute about half the retail price of all petroleum and as much as 80 per cent of gasoline prices in Italy.

Reopening of the Suez Canal will be a primary objective of cost-cutters. Even prior to the OPEC tax increases West European oil costs last year rose, or at least failed to fall in accordance with the long-term trend, because of price increases attributed to the tanker shortage. The consensus is that a reopened Canal would end the tanker shortage, although there is no consensus on the current severity of the shortage or its probable duration if the Canal remains closed. Without the Canal, the oil industry believes that the shortage would last another two years or more. Some observers are of the view that the shortage is exaggerated, that last fall's exorbitant tanker charter rates stemmed from excessive oil stock-piling in Europe as a precaution in the event of an oil supply crisis. Whatever the case, there was no crisis, Europe had a warm winter, above-normal amounts of Persian Gulf oil moved to Europe and average tanker charter rates have been falling since November, aided by the Tapline reopening of January 29. Ending the tanker shortage is expected to reduce transportation costs and thus consumer oil prices, offsetting to some extent the impact of the OPEC tax increases. Reopening the Canal also is seen as a means of reducing the ability of short-haul producers to disrupt oil flows by decreasing production.

In the longer run, Europe and Japan most likely will seek to limit energy costs by ensuring competition among fuels and sources of supply through greater diversification of both. Toward this end they may assume more control over domestic energy supplies and, through their own national oil companies, may seek expanded direct access to foreign oil resources, often in partnership with national oil companies

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of the oil-exporting countries. Such action may not encroach on private oil companies' current holdings so much as it may restrict their growth. Outside North America and the Communist bloc, government oil companies since 1963 reportedly have increased their share of crude oil production to about 10 per cent and their share of refining and marketing to about 15 per cent of total volume. The integrated international oil companies, largely American, lost ground to both governments and "independent" (non-integrated) companies and in 1969 had about 75 per cent of production and about 55 per cent of marketing and refining.1/

In diversifying their energy supplies, Western Europe and Japan may also profess greater interest in Soviet oil and natural gas, although the USSR does not now have ample export surpluses.

The new price relationships among fuels should restrain oil prices over the long run. Coal may regain some popularity and natural gas and nuclear power development may accelerate. Higher cost oil fields in remote or offshore areas are now more viable. One calculation puts potential North Sea oil profits at over $1 per barrel,2/ assuming the Norwegians do not raise taxes to OPEC levels. Such profits should hasten North Sea development.

The outlook for stability depends on the answers to several questions, among them:

-- What commitments were made? A preliminary review of incomplete reports indicates that the OPEC countries assumed few obligations other than fixed tax rates for periods which range from five years in the Persian Gulf and Libya down to nine months in Venezuela and no fixed period in Indonesia. There is ambiguous treatment of such issues as the companies' commitment to operate at least one exploratory drilling rig each in Libya. Most important, outside the Persian Gulf there seem to be no commitments regarding oil production levels. In the Gulf the companies are permitted to increase production when necessary, and undoubtedly will. This seems to permit several exporters to interrupt or reduce production. In practice only Libya is in a position to do so for extended periods without outside assistance, but because of its location Libya can influence the tanker situation as long as the Suez Canal remains

1/ Petroleum Press Service, January 1971, p. 11

2/ PIW, March 15, 1971, p. 4

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closed by manipulating production. After the April 2 agreement the Libyan oil minister reportedly told a domestic audience that Libya had reserved the right to cut off supplies in support of other countries.1/ With its overflowing treasury and sub-par oil reserves Libya is in a position to reduce production, if only to enforce the companies' exploration commitments, but may decide that its long-run interests are best served by an orderly control program.

-- Will the oil governments, or their successors, keep their commitments? There is little confidence that they will because there is no effective legal method for commercial concerns to enforce agreements with, or commitments by, sovereign governments. Venezuela and Libya, citing sovereignty, seemed to break existing explicit or implicit commitments in seeking their new revenues. Libya strenuously resisted a five-year commitment in part on the ground that this would violate its sovereignty. There is some concern that the new Libyan agreement may undermine the Persian Gulf agreement, since Libya's terms are at the upper limits of comparability with the Tehran agreement. Some minor technical adjustments may be necessary in the Gulf while Iran's Shah has informed us in the wake of the Libyan pact that he is reviewing his agreement for loopholes. The OPEC agreements, of course, do not correct the basic problem - the potential discrepancy between oil's market value and the desires or needs of the less-developed oil exporters. Venezuela, for example, abrogated its old oil tax law when it still had one year to run because the country faced a budget deficit. The new taxes legislated in December 1970 were made effective as of January 1, 1970. If needs again exceed revenues and circumstances permit, some exporters may again exercise their sovereignty.

-- How will the Japanese and European governments react? [redacted] E.1

[redacted] Europe certainly will step up pressures to reopen the Suez Canal. In some Western markets Soviet oil and natural gas may reach undesirable levels, although this is unlikely in the near term and the Soviets undoubtedly will demand whatever prices the market will bear. So far, most governments continue to study the situation.

1/ London Financial Times; April 8, 1971, p. 15, quoting Libyan News Agency.

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-- Will the market sustain the new prices? It should for a year or more. OPEC tax terms cover over 90 per cent of current European and Japanese oil supplies. Adjustment of energy arrangements to reduce reliance on OPEC oil, if possible at all, will take a few years. This situation led MIT's Dr. Adelman to conclude that OPEC can run its recent power play several more times without reducing sales. As he suggested, however, in the longer run competition may produce a new oil surplus, causing price cutting and efforts to play energy suppliers off against one another. This could divide OPEC to the consumer's advantage but the process could affect the agreements and supply stability.

-- What is OPEC's actual strength vis-a-vis the consuming nations? At the moment the adversaries are sizing one another up. OPEC's chief weapon is the interruption of oil supplies to win its demands. As noted, Mediterranean oil suppliers are the most embargo-prone but an embargo's effectiveness is seasonal. This is not a propitious time because with warmer weather here, Western Europe--the target of an embargo--has ample oil stocks. A supply interruption would have to be prolonged to win new concessions and few oil exporters can do without income for extended periods. Europe's vulnerability increases after midyear but it appears that stocks are being maintained at high levels this year. Reopening the Suez Canal would take much of the sting out of isolated embargo threats. OPEC's further weapon is the nationalization of the international oil companies' production facilities but some of the old impediments to such action still linger. The international majors still control three-fourths of production and over half of distribution in the international market. More important, few OPEC members could operate nationalized oil industries without foreign assistance, official or private, replacing one foreign presence with another, quite possibly at no net gain to host country national interests if the nationalization is contentious. Eventual host government control seems a certainty but OPEC's moderate members and even the weaker radicals may opt for some form of gradual or evolutionary take-over during the 1970s rather than a disruptive seizure on the Algerian pattern. They may wait until 1975 but probably not until 1979, when the first of the pre-World War II concessions, that of the Consortium in Iran, legally expires.

-- What is OPEC's next move? This may not be known until after OPEC's next general meeting, scheduled for Vienna, July 12.

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Conclusions: Although there is little confidence that the five-year agreements will endure without alteration or that further supply interruptions of some magnitude will not occur, it is too early to predict what will happen next. A breathing spell of at least a few months seems to be indicated while oil producers and consumers measure their gains and losses as well as their respective strengths. More consumer government intervention in both the demand and supply sides of the world energy structure also seems to be indicated to ensure stability but it will take some time to decide on the possible lines of action. Some such intervention seems indicated as a means of ensuring competition and of enforcing agreements by elevating them to governmental pacts. OPEC still holds the initiative but may not have the leverage it had last year; its intentions may be known within a few months.

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TABLE I

Approximate First Year Effects on Major Markets of OPEC Tax Increases 1/

Region	Estimated Affected Annual Imports	Old Cost Per Barrel 2/	Cost Increase per Barrel ($)	Gallon	% Chg.	Total Import Cost Increase	% Chg. 3/
Western Europe	4.5 billion bbls.	$2.25	50-60¢	1.2-1.4¢	22-26%	$2.2-2.7 billion	1.7-2.1%
Japan	1.5 billion bbls.	$1.85	40¢	1¢	22%	$ 600 million	2.3%
United States	3.0 billion bbls.	$3.50	10¢	.2¢	3%	$ 300 million	.7%

1/ Calculations assume increases shifted fully to consumers.

2/ 1969 figure adjusted slightly upward to allow for temporary transportation cost increases in 1970.

3/ 1971 projection based on 1969 import figures for Europe and Japan, 1970 imports for the US.

These are preliminary approximations for crude oil (and Venezuelan products) based on recent trade patterns, and initial reports of tax increases in the Persian Gulf, Indonesia, Venezuela and Libya since last summer. In some cases the increases occurred in two stages. These estimates also assume that in the unfinished negotiations, Algeria will win Libya's tax terms while Nigeria and Eastern Mediterranean pipeline oil will increase by at least half the Libyan increase. Smaller automatic annual increases scheduled through 1975 are not included here.

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TABLE II

OPEC Chronology - Government Revenues Per Barrel of Exports*
(Approximations)

Country	Libya[3]	Persian Gulf[4]	Venezuela[5]
Original[1] 1970 Take	$ .98	$ .87	$ .98
First Increase	29¢(30%)	10¢(12%)	None
Result	$1.27	$ .97	
Effective Date	Sept. 1, 1970	Nov. 14, 1970	
Final Increase	62¢(50%) 48¢(38%)	28¢(29%)	44¢
Final Result	$1.90 ($1.75)	$1.25	$1.42
Effective Date	Apr. 2, 1971	Feb. 15, 1971	March 18, 1971
Overall Increase	94%(79%)	44%	45%
Production Cost[2] (at wellhead)	$ .25	$ .14	$ .50
Cost Price at Port	$2.15	$1.39	$1.92

* Omits increases scheduled through 1975 for Libya and the Persian Gulf.

1/ Government "Take" is combined royalty and tax income.

2/ Production cost varies from well to well and country to country. Various cost figures are cited elsewhere and result in a variety of tax and final cost estimates for the same oil.

3/ The average for all Libyan crude oil. Figures in () are those which are to come into effect when the Suez Canal opens and tanker rates fall.

4/ 34° crude oil, a major export type, used in this illustration.

5/ The average for both Venezuelan crude oil and refined products. Due to changes in definitions, both old and new Venezuelan statistics are particularly tentative calculations.

Indonesia, an OPEC member and a relatively small producer, is omitted due to the complexity of its price system. Roughly speaking, the government take is about 60% of the new fob price of $2.21.

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